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No. 82-236

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

LOUIS STERNBACH & COMPANY,

Petitioner,

—against—

HOWARD SIROTA, FAMILY RESTORATIONS, A Partnership, on behalf of themselves and all others similarly situated,

Respondents.

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Alleged Questions Presented for Review

There are no proper questions presented for review here. Sternbach's "questions presented for review" are not fairly reflected by the record.

Sternbach seeks certiorari because of claimed errors by the Court of Appeals in

(i) allegedly applying the doctrine of *respondeat superior*,

(ii) allegedly finding scienter on the basis of "reckless behavior" as opposed to actual knowledge, and

(iii) allegedly inferring fraudulent intent "solely on the basis of claimed inadequate performance of auditing procedures and tests."

As demonstrated below, the Court of Appeals found that there was sufficient evidence to justify the jury's finding of fraud on Sternbach's part. Specifically, (i) the Court of Appeals found that the credibility of Mr. Cole, Sternbach's partner in charge of the Solitron audit, was for the jury to evaluate (*respondeat superior* was an issue neither raised by the parties nor discussed by the courts below), (ii) the jury and the Court of Appeals found that Sternbach's liability was founded on actual knowledge rather than "reckless behavior" and (iii) the Court of Appeals did not find fraudulent intent "solely" on the basis of an inadequate audit but because of a "combination of facts" including knowledge of the fraud on the part of Mr. Cole, and Sternbach's claim that it had performed certain tests and procedures, tests and procedures which perforce would have revealed the fraud.

Statement of the Case

This securities class action was brought on behalf of open market purchasers of stock of Solitron Devices, Inc. Plaintiffs (respondents here) oppose the petition for a writ of certiorari, brought by defendant Sternbach & Co. (petitioner here).

After a two-week trial, the jury found that the defendants had committed fraud. During 1967-70, Solitron announced to the public that its profits for 1967, 1968 and 1970 had increased by leaps and bounds. When the government attempted to recover Solitron's excess profits on government business, pursuant to the Renegotiation Act of 1951, Solitron admitted that its profits had been grossly overstated so that there were no excess profits to recover. The individual defendants, officers and directors of Solitron, actually knew of the income overstatements. Class

members were damaged when they purchased Solitron stock at prices inflated by Solitron's false earnings. (A-46-47).*

Sternbach & Co. certified Solitron's false financial statements for 1967, 1968 and 1970. The jury found that Sternbach had *actual knowledge* of the fraud involved at the time the statements were certified. (A-57, 59-60) This was based upon substantial evidence, including among other things, that Mr. Cole, the Sternbach partner in charge of the Solitron audit, had been directly informed that transactions he classified as sales were actually consignments. It was also based upon Mr. Cole's claim that in fact Solitron's financial statements were accurate in all respects and that Sternbach had performed various auditing procedures and techniques which would have disclosed the overstatements if they existed. The jury resolved the issue of fact as to whether Solitron's financial statements were false and misleading in plaintiffs' favor. (A-71) In view of Sternbach's admission that it performed auditing procedures and techniques which would have disclosed the falsities, the jury was justified in concluding that Sternbach certified Solitron's false figures with actual knowledge of their falsity. (A-59-60)

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* References (A-) are to the appendix annexed to Sternbach's petition.

REASONS WHY THE WRIT SHOULD BE DENIED

POINT I

There Was Sufficient Evidence to Support the Jury's Finding That Sternbach Had Actual Knowledge of the Fraud Involved.

The Court of Appeals reversed the District Court's grant of Sternbach's motion for judgment n.o.v. based on that court's determination that there was insufficient evidence for the jury so to find and reinstated the verdict. Recognizing that whether the evidence was sufficient to support the jury's verdict raises no issues worthy of review by this Court, Sternbach attempts to concoct such issues by citing alleged conflicts involving recklessness and actual intent, *respondeat superior* and controlling persons, and whether an inadequate audit can give rise to an inference of fraud. Whether or not these issues are worthy of review by this Court, such issues do not exist in this case.

(1)

The Court of Appeals held in support of its reversal of the District Court, that there was sufficient evidence to justify the jury's finding that Sternbach had *actual knowledge* of the fraud. The District Court had specifically refused to give a recklessness charge thereby eliminating recklessness as an issue in the case with regard to Sternbach:

> "It is not enough to find that Sternbach acted negligently or falsely or even recklessly . . . you must find that Sternbach acted with *actual knowledge*." (1836a) (emphasis added)*

* References to "a" are to the record.

(ii)

The Court of Appeals held that the credibility of Mr. Cole, the Sternbach partner in charge of the Solitron audit was for the jury to evaluate "in the face of evidence suggesting he was on notice" that Sternbach's certification of Solitron's financial statements were fraudulent. Mr. Cole's knowledge is Sternbach's knowledge; it is not imputed to Sternbach on principles of *respondeat superior*, nor does Sternbach contend otherwise.

Furthermore, Sternbach raised no objection to the District Court's instructions* on Sternbach's knowledge nor did it raise the *respondeat superior* issue in the Court of Appeals. It is presented here for the first time in a desperate effort to gain certiorari.

(iii)

The Court of Appeals held that based on Sternbach's claim to have performed "various costing procedures and

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* The instructions were as follows:

"The second element the plaintiffs must prove is that Louis Sternbach & Company acted intentionally. To hold the accountants liable on this theory, you must find that Sternbach or one of its partners or accountants had actual knowledge of a primary fraud by Solitron. It is not enough to find that Sternbach acted negligently or falsely or even recklessly. To satisfy the second element, you must find that Sternbach acted with actual knowledge. *You will find that Sternbach had knowledge if you find that a responsible person in the company concerned with its work on the Solitron Devices account had such knowledge.*

Now, your common sense will tell you that if the elevator operator or the doorman had such knowledge it would not be imputed to the company because it is not the job of the elevator operator or doorman or the file clerk, for example, to conduct audits or certify financial statements or make representations to the persons who buy and sell securities. *But if a responsible person, such as an accountant or partner, had such knowledge, it would be imputed to the defendant Sternbach.*" (emphasis added) (1836a-1837a)

tests on Solitron's 1967-70 inventory" which would have revealed that the inventory was grossly overstated, the jury was entitled to conclude that Sternbach knew its certification was false. Despite Sternbach's claim at trial that Solitron's financial statements were totally accurate, the jury found those financial statements to be materially false. The jury was then entitled to find that Sternbach knew of the falsities in view of its claimed use of tests and procedures which would have revealed those falsities. It was thus not Sternbach's *inadequate* audit, as asserted in its petition, but rather its claimed adequate audit, which, along with other evidence, supports the jury verdict:

> "The *combination of these facts* leads us to the conclusion that there was sufficient evidence for the jury to infer that Sternbach knew that its certification of reports overstating inventory was fraudulent." (emphasis added) (A-60)

McLean v. *Alexander*, 599 F.2d 1190 (3rd Cir. 1979) and *Adams* v. *Standard Knitting Mills, Inc.*, 623 F.2d 422 (6th Cir. 1980), *cert. den.*, 499 U.S. 1067 (1980) do not in any way conflict with the decision here. In each of those cases, the court merely held that there was insufficient evidence of scienter to justify imposition of liability. In *McLean*, among other things, confirmation of fifteen out of sixteen questioned transactions were received. *Adams* involved a failure accurately to describe restrictions on dividends. Here, unlike *McLean*, confirmations were *not* received, and here, unlike *Adams*, there was massive overstatement of inventory, coupled with claims by Sternbach that it had employed techniques and procedures which would have disclosed such overstatements.

That different evidence may support different verdicts by different triers of fact hardly means, as Sternbach as-

serts, that there is any conflict among the circuits justifying the grant of certiorari.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari to the United States Court of Appeals for the Second Circuit should be denied.

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Respectfully submitted,

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